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November 13, 2007

Macias Gini & O'Connell LLP  
Attn: Jim Godsey  
402 West Broadway, Suite 400, Room 7A  
San Diego, CA 92101

Dear Mr. Godsey:

***Preservation of Benefit Plan ("POB Plan") - Analysis regarding (1) whether the POB Plan was properly established by the City, (2) whether SDCERS funding of excess benefits from pension system assets could disqualify SDCERS as a "qualified plan" within the meaning of the Internal Revenue Code, and (3) related disclosure in the FY 05 CAFR.***

### **Background**

In filings with the Internal Revenue Service SDCERS has admitted several plan and operational failures in violation of the Internal Revenue Code.<sup>1</sup> Any one of those failures could result in SDCERS losing its status as a "qualified plan," which would have dramatic tax consequences to plan participants.<sup>2</sup> This memorandum addresses plan failures related to SDCERS payments of benefits in excess of those permitted under Section 415 of the Internal Revenue Code for qualified plans.

### **Discussion**

Section 415 of the Internal Revenue Code establishes limits on the benefits that a qualified plan can pay to plan participants and their beneficiaries. The City may, in order to pay excess benefits, establish pursuant to Section 415(m) of the Internal Revenue Code a plan separate from SDCERS, referred to as a "qualified governmental excess benefit arrangement"

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<sup>1</sup> 22 August 2007 letter from Ice Miller to Joyce Kahn Manager, EP Voluntary Compliance, Joseph Grant, Director of Employee Plans, James E. Holland, Manager, EP Technical, Maxine B. Terry Program Coordinator, Andrew Zuckerman, Director of Rulings and Agreements (at SE:T:EP:RA:VC, PE-4L2, 111 Constitution Avenue, NW Washington D.C., and to Paul C. Hogan IRS Agent/EP Specialist, see draft VCP Compliance Statement Exhibit 1.

<sup>2</sup> Ice Miller "415(b), (c), and (n) Compliance Strategy Report, p. 1, "Importance of Code Section Compliance."

(“QEBA”). Unlike SDCERS, a QEBA must be funded on a cash basis and cannot be funded over time on an actuarial basis. The intent is that SDCERS will advise the City each year of the amount that would be payable to retirees and their beneficiaries in excess of the limits of Section 415 of the Code, and the City will annually cash fund such amount. This did not occur. Rather, SDCERS has paid excess benefits for a number of years from assets of the retirement system, amounting to greater than \$8 million to 102 plan participants.

The City, pursuant to Ordinance O-18930, adopted March 19, 2001, purported to establish a QEBA. Concerns with the establishment of the QEBA, its funding, and the payment of excess benefits are the subject of a detailed Ice Miller report. This memorandum is intended to only briefly describe such concerns, for the purpose of making apparent related disclosure deficiencies in the FY 05 CAFR, and why they should be corrected before the FY 05 CAFR is submitted to the City Council. Although the FY 05 CAFR was initially approved by the Disclosure Practices Working Group, the DPWG did not have access to the Ice Miller reports until after that approval. In addition, although the Mayor’s office has posted the FY 05 CAFR on the City’s website, the FY 05 CAFR has not yet been received and filed by either the City’s Audit Committee or the City Council.

Failure by the City to Properly Establish QEBA. The City purported to establish a Preservation of Benefit Plan in March 2001. Although the City Charter permitted the Council to adopt a pension system, it does not provide for the enactment of the Preservation of Benefit Plan. The City Attorney’s Office is of the opinion that a Preservation of Benefit Plan can only be established by a vote of San Diego City voters.

Failure by SDCERS to Properly Administer Excess Benefits. Although the City adopted an ordinance in March 2001 with the intent of establishing a QEBA, SDCERS did not adopt a “Preservation of Benefit Plan and Trust” until February 2007. Between March 2001 and February 2007, SDCERS, in violation of the Internal Revenue Code and its fiduciary obligations to plan participants used retirement plan assets to fund excess benefits. Those improper payments were in excess of \$8 million. By letter of 22 August 2007 SDCERS’ tax counsel informed the Internal Revenue Service that “102 participants have at some point in their retirement exceeded the 415 limit.”<sup>3</sup> In the 22 August 2007 letter Ice Miller stated that “the total

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<sup>3</sup> 22 August 2007 letter from Ice Miller to Joyce Kahn Manager, EP Voluntary Compliance, Joseph Grant, Director of Employee Plans, James E. Holland, Manager, EP Technical, Maxine B. Terry Program Coordinator, Andrew Zuckerman, Director of Rulings and Agreements (at SE:T:EP:RA:VC, PE-4L2, 111 Constitution Avenue, NW Washington D.C., and to Paul C. Hogan IRS Agent/EP Specialist, see Exhibit 1.

excess benefits, with interest to 6/30/07, total \$8,160,027.”<sup>4</sup> Enclosed with the letter was a chart and written criteria used to calculate the 102 IRC 415 excess payments.<sup>5</sup>

Related Disclosures in FY 05 CAFR. The QEBA is described in very summary fashion in one paragraph in Note 12 to the FY 05 financial statements. A more detailed discussion is set forth on page 19 of the accompanying Letter of Transmittal. The use of the Letter of Transmittal for a more detailed analysis than that provided in the Notes raises a concern because the Letter of Transmittal is not part of the audited financial statements. Separate from that general concern are the following particular disclosure concerns:

- no discussion that greater than \$8 million of excess benefits was paid to 102 participants (simply a general reference that “benefits awarded to some plan participants exceed the amount permitted”)
- statement that a Preservation of Benefit Plan was established by City Council in March 2001 does not reflect concerns of the City Attorney’s Office that such a Plan can only be established by a vote of the electorate, nor does it address the subsequent failure by SDCERS to implement the council action
- a liability of approximately \$22.8 million is described relating to “excess benefits for eligible active members of the system,” with no description of the magnitude of the liability for retired members
- the statement that the “Preservation of Benefit Plan is a qualified governmental excess benefit arrangement” is incorrect, because Ice Miller has submitted to the IRS a private letter ruling request on this point which has not yet been acted upon
- the statement that “The Preservation of Benefit Plan is administered by the SDCERS Board separately from the City’s 401(a) pension plan” is misleading without further explanation, because SDCERS did not separately administer such plan between March 2001 and February 2007, nor have any payments been made through the plan to date

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<sup>4</sup> 22 August 2007 letter from Ice Miller to Joyce Kahn Manager, EP Voluntary Compliance, Joseph Grant, Director of Employee Plans, James E. Holland, Manager, EP Technical, Maxine B. Terry Program Coordinator, Andrew Zuckerman, Director of Rulings and Agreements (at SE:T:EP:RA:VC, PE-4L2, 111 Constitution Avenue, NW Washington D.C., and to Paul C. Hogan IRS Agent/EP Specialist, see Exhibit 1.

<sup>5</sup> SDCERS Retroactive 415 Testing for VCP (2007), Exhibit 2; Exhibit A: Cheiron Proposed Procedures on Retrospective 415(b) Testing, Exhibit 2.

### **Conclusion**

The San Diego City 2005 financial statements must be corrected to address each of the disclosure deficiencies outlined above. Such corrections must be made to the Notes, not simply the Letter of Transmittal, in order to assure that the auditors review such corrections.

Moreover, the issue of whether a preservation of benefit plan can be established without a vote of San Diego voters must be resolved. If a vote is required, then the City Council should put the issue on the ballot for the June 2008 election. The City must also determine if and how to recover the excess benefit paid in violation of IRC 415.

We have discussed these issues with you and the need to conduct an illegal acts investigation. The City Attorney has initiated such illegal acts investigation and will provide its findings when such investigation is completed.

MICHAEL J. AGUIRRE, City Attorney

By

Michael J. Aguirre  
City Attorney

MJA:jdf

cc: Honorable Mayor  
Council President Peters and Councilmembers  
Andrea Tevlin, Independent Budget Analysis  
DPWG